Claremont Colleges
working papers in economics

Claremont Graduate University • Claremont Institute for Economic Policy Studies • Claremont McKenna College • Drucker Graduate School of Management • Harvey Mudd College • Lowe Institute • Pitzer College • Pomona College • Scripps College

April, 1999

Crime and Punishment: Some Lessons of the Ruble Crisis

Thomas D. Willett

Claremont Graduate University
Department of Economics
160 E. 10th Street
Claremont, CA 91711
Phone: 909-621-8787
FAX: 909-621-8460

There are as many interpretations of the recent Russian crisis as there are varieties of caviar. George Soros argues that the recent rash of national currency crises is the result of an inherent instability in financial markets. The official Russian government version is much the same - the ruble fell victim to the excessive pessimism of investors still overreacting to the shock of the Asian financial crisis. The week before the Russian devaluation and announcement of a debt moratorium (i.e. partial default), Prime Minister Sergei Kirigenko argued there were no concrete reasons for the behavior of the currency and financial markets, just psychological ones.

By then Kirigenko was right that psychology had become important: an element of panic had set in. Markets had almost completely lost confidence in the ability of the Russian government and banking system to honor their short-term debts. This pessimism, feeding on itself, assured that investors' worst fears would be realized: Russia did fall victim to self-fulfilling speculative expectations. But as in the other major currency crises of the 1990's - the European Monetary System in 1992 and 1993, Mexico in 1994, South East Asia in 1997 and Brazil in 1999 - these speculative attacks did not come out of the blue. There were sound economic reasons. Once a speculative crisis gets underway financial markets do often overreact, with optimism turning to excessive pessimism. But such market dynamics only account for some of the details of the Russian crisis, not the basic cause.

The market may have gone too far when it pushed up the interest rates on short term ruble denominated Russian government debt to over 200 per cent; but in truth a substantial rise in interest rates was quite justified in order to reflect the genuine riskiness of ruble assets generated by the underlying economic and financial conditions.

Thomas D. Willett is Director of the Claremont Institute of Economic Policy Studies and Horton Professor of Economics at Claremont Graduate University and Claremont McKenna College.

This essay traces out some of the key developments that led to the Russian crisis and highlights the strong similarities to the other major currency crises of the 1990s. The primary causes were neither the instabilities of the international financial markets nor the bail out policies of the International Monetary Fund (as charged by critics of the left and the right respectively). They are found rather in the forces of domestic political economy and the technical difficulties of operating regimes of pegged exchange rates. In a world of high international capital mobility countries face a starker choice between the extremes of genuinely fixed and flexible exchange rates. The compromise of adjustably pegged rates, so often used in the past, doesn't work now that billions of dollars can cross national borders in a few hours. Rather than stabilizing markets, such pegged rate regimes have become a recipe for crisis. Fixed exchange rates in the form of a common currency or a currency board make sense for some countries, but most will find that some form of flexible rate regime is their best option.

The strategy of attempting to foster economic reform efforts in Russia through the provision of "conditional" international financial assistance clearly failed, but this was a calculated gamble that was likely well worth the risks. The costs of a less reformist, more nationalistic Russia are huge - both to the welfare of the Russian people and to global security. Thus on both humanitarian and national security grounds, Western financial support was justified. Even though it was clear that the chances of success were much lower than for the post World War II Marshall plan, we had to try. The mistake was that for domestic political reasons Western governments forced the IMF into being the primary vehicle for such a risky investment. As a result of the failure of this strategy the credibility of the IMF's stabilization programs (already seriously eroded) has been further damaged. Thus the Russian crisis points to important reforms that are needed now to strengthen the IMF.

Pessimists view the recent series of currency and financial crashes around the globe as signs of impending global financial collapse. Our crystal ball shows a sunnier outlook. The widespread abandonment of pegged exchange rates, in the wake of recent crises, is encouraging. Flexible exchange rates are no substitute for the tough reforms needed to lay the foundations for sound economic and financial infrastructures and replace cronyism with competition. But flexible rates will guard against some of the worst consequences of bad economic policy. This damage control role of flexible rates is far from glamorous but, in an imperfect world, it is invaluable.

Blaming Financial Liberalization Misses the Point

It's hard to remember that only a few years ago financial liberalization was the rage around the globe. In the wake of the recent crisis, there has been a dramatic change in attitudes. A chorus of cries to increase national and international regulation of international capital flows is now being heard. There is no question that some of the financial liberalization of the past decade was premature. Advocates often paid too little attention to the preconditions necessary for liberalized markets to work well. There is a vast difference between liberalizing competitive markets peopled by well trained managers and staff and liberalizing markets still dominated by monopoly elements and staffed by inexperienced personnel. Today, however, there appears to be a serious danger that the pendulum is swinging back too far. It was not inherent flaws in the behavior of financial markets than caused the recent crisis, although flaws did increase their severity.

There are costs as well as benefits to most policies. What financial market liberalization does is increase the benefits of good economic policies and the costs of bad policies. And bad policies include not only the lax monetary and fiscal policies of the traditional high inflation crisis episodes, but also the harder to spot problems of poorly structured banking and financial systems and cronyism in the allocation of credit. No wonder then that officials from countries with poor economic policies frequently try to deflect the spotlight onto those perennial villains - the greedy speculators.

What makes analysis of this issue so tricky is that international financial markets have not behaved according to the cool, calculating standards of mainstream economic theory. They have at times shown distressing tendencies toward herd behavior and panic. And the critics are quite right that liberalization must be implemented with care. Where government policies still create perverse incentives the liberalization of markets will often make matters worse. This was clearly illustrated in the recent Asian crisis where many local banks and businesses borrowed excessively from abroad because they believed that their national governments would protect them from the effects of devaluation. In Russia, the combination of liberalization with perverse economic incentives was if anything, even worse. Clearly the proper sequence of reform is to first create proper economic infrastructure of accounting and managerial practices and a competitive environment and then liberalize capital flows. The Asian crisis was replayed in Russia, not because financial markets never learn, but because once again domestic financial actors believed that they had the political clout to get the government to bail them out if their investments went south.

That is just what was done by the big Russian banks. They borrowed like mad to purchase high yielding Russian government securities. When interest rates soared in the wake of the Duma's nixing of the reform program, the resulting collapse of bond prices threatened the solvency of a number of these banks. When these financial oligarchs learned that the government planned to let their institutions go bankrupt, they successfully lobbied Mr. Yeltsin to fire Mr. Kirigenko and his cabinet and nominate Mr. Crony Capitalism himself, Viktor Chernomirdin, as Prime Minister. Market liberalization in the face of the special interest problems of crony capitalism can be quite costly. But the fundamental problem is the crony capitalism, not free markets.

What the critics of financial market liberalization often miss is that far from being too ready to generate crisis, international investors have tended to be gullible and wait too long to react to worsening economic conditions. True, once crises have hit, financial markets have frequently overreacted. But seldom, if ever, have the markets been the cause of unjustified speculative attacks. Recent developments in international monetary theory have focused on the possibilities of self fulfilling speculative attacks, and the crises of the nineties have included several instances where such behavior may have occurred, including both the crisis of the European Monetary System in 1993 and the recent Russian crisis. But self-fulfilling speculative attacks need not be unjustified attacks. The first generation of speculative attack models saw a world of black and white. Either the underlying fundamentals were sound or they were not. As soon as the situation changed from the first to the second category, a successful speculative attack would immediately be launched. The latest generation of speculative attack models is much more realistic. They recognize shades of gray. A country's fundamentals may be so strong that no speculative attack is justified even in the face of typical adverse developments. On the other hand, a country may be so clearly headed for trouble that the only question is when the speculative attack will come. But between these poles is a third category in which a country has allowed its underlying fundamentals to slip into a zone of vulnerability.

In this zone, a crisis isn't inevitable if good luck holds, but the country is quite vulnerable to adverse shocks such as political assassinations as in the case of the Mexican peso, pegging to a strengthening currency as in the case of the Thai baht, a slump in the price of a major export, as was the case for Russia with oil, or even a speculative crisis in a neighboring country, as happened to Indonesia after the fall of the Thai baht. Normal swings in the degree of optimism or pessimism of investors can be a similar source of shock. There is no question that the Asian crisis caused a substantial swing in investors attitudes toward emerging markets. Burnt badly in Mexico and then again in South East Asia, the risk premium investors demanded on all emerging markets debt rose substantially. This was as little Russia's fault as was the fall of oil prices. But this was not the result of irrational panic in the global financial markets.

Panic eventually did hit the Russian market, but this was only after the crisis was already in full swing. The Russian government's fault was that it had allowed the underlying economic situation to deteriorate to a position of substantial vulnerability. In such a situation negative developments tend to feed on themselves and suddenly a level of maturing debt that would have been easy to roll over a month before becomes problematic. The Russian default in turn set off a flight for quality and substantially raised the cost of borrowing for emerging markets across the globe.

How did Russia fall into this position of vulnerability? The story is sad because despite only half hearted efforts at tax reform and combating crony capitalism, Russia had made enormous economic progress, especially in getting inflation under control. In 1992 inflation rose to over 1,500 percent. By 1996, it had been brought down under 100 percent, in 1997 to under 20 percent, and in early 1998, down to the single digit range.

The crises of the nineties illustrate a number of empirical points. One is that inflation is not the only cause of weak currencies and balance of payments crises. Indeed, contrary to previous experience, none of the major crisis countries of the 1990s were suffering from high inflation. The monetary approach to balance of payments analysis is quite correct in stressing that excessive rates of money growth are a sure way to currency crisis, but it does not follow that the absence of excessive money approach will assure balance of payments stability. There are a number of other factors such as capital flows and commodity market developments that can enter the picture. In the case of Russia, the fall in oil prices caused a drop in export proceeds between the first half of 1997 and the first half of 1998 of more than $15 billion at an annual rate. That is a substantial shock that required a midsized adjustment in the exchange rate to compensate. However, Russia, like Mexico, had been following a strategy of using its exchange rate peg as an instrument to control domestic inflation rather than to adjust its balance of payments. Such exchange rate based stabilization policies were popularized by the apparent success of the members of the European Monetary System in conquering inflation during the 1980s. They were subsequently urged on a broad range of emerging market economies by a number of Western European governments, many academic economists, and at times, the IMF. This strategy of using the exchange rate as a nominal anchor for domestic prices does sometimes work. Argentina, Estonia, and France are all examples. But recent experience has made clear that it is a high risk strategy.

The Dangers of Pegged Exchange Rates

The reason is not hard to understand. A basic tenet of international monetary theory is that in the long run it is not possible to maintain simultaneously a pegged exchange rate, freedom from controls on trade and capital flows, and independence of domestic macroeconomic policy. This is often labeled "the unholy trinity". What makes the simple logic of this proposition difficult for policy makers to sometimes grasp is the proviso, in the long run. In the short run, these objectives will not always be in conflict and this can lead officials to forget about this fundamental long run constraint. This oversight was a major cause of the EMS crises of the early 1990s.

The pegged rate strategy will work as long as policy makers are willing to adjust domestic policies as necessary to protect the currency. Indeed this is the purpose of using the exchange rate to discipline domestic policies. There are two basic problems with the strategy, however, and both are vividly illustrated in the ruble crisis. First, the cause of balance of payments problems may not be related to domestic macroeconomic policies. That was the case for Russia with the fall in oil price. The approximate economic response to this type of shock is an adjustment of the exchange rate, not a deflation of the domestic economy.

Secondly, even where domestic policy adjustments are the appropriate response, commitment to maintaining the peg may not be sufficient to induce the needed domestic policy response. This was the case with the Duma's unwillingness to accept the stabilization program agreed to by the IMF and the Russia's Executive Branch. Typically when the discipline effects of pegged rates fail to be sufficient, the result is a currency crisis that undermines much of the progress made toward stabilization. This was the case with the Mexico peso. It is being repeated in Russia. Where the domestic political forces for stabilization are strong, use of an exchange rate linked anti inflation strategy can sometimes help provide better results, but where domestic support is weak, then efforts to use exchange rate policy as a source of discipline are likely to backfire.

The recent crises also highlight the basic difficulties of effectively implementing a strategy of adjustably pegged exchange rates in a world of high capital mobility. One of the reasons economics is appropriately labeled the dismal science is that economists focus on the costs as well as benefits of policies. There are few policies, no matter how impressive their cost-benefit ratios, that do not bear costs. Exchange rate policy is an important case in point. Fixed exchange rates are typically good for international trade but constrain domestic macroeconomic policies. Flexible exchange rates are often less attractive for international trade but allow greater domestic macroeconomic freedom. Governments typically do not like to have to make stark choices. For understandable reasons they prefer to avoid the extremes of both fixed and floating exchange rates and try to find some compromise that maximizes benefits relative to costs.

The idea of the adjustable peg, on which the post war international monetary system negotiated at Bretton Woods was based, was just such a compromise. Exchange rates would normally be pegged, but in extreme circumstances of fundamental disequilibrium could be adjusted instead of forcing domestic macroeconomic policies to generate domestic inflation or deflation. The problem is that if pegs are not adjusted frequently then disequilibrium builds up and speculators have a field day. The only question is whether the peg will be adjusted, not in which in direction will it move. This is heaven for the Soroses of the world.

The higher is international capital mobility, the greater are the difficulties of operating such compromise systems because of this one way speculative option. Among the industrial countries, international capital mobility had already risen sufficiently by the late 1960s to begin the process which led to the collapse of the Bretton Woods adjustable peg in the early 1970s. In the 1990s capital mobility has risen to this level for many of the emerging market economies as well.

High capital mobility does not tilt the balance of cost-benefit calculation strongly in the direction of either fixed or flexible exchange rates, but it makes it hard for countries to operate compromise systems. Even with high capital mobility, it is possible for compromise systems to operate without crises if pegs are adjusted sufficiently frequently and are accompanied by reasonably wide bands around their central parties. Indeed, a few countries such as Chile, Hungary and Poland have used such strategies quite successfully, as did members of the European Monetary System during the first half of the 1980s.

Experience shows that it is difficult for governments to continue to operate such regimes with sufficient flexibility, however. Over time, there is a strong tendency for such adjustable pegs to evolve into more rigid regimes. The problem, as much political as economic, is that countries face short-term incentives to postpone adjustments in hopes that they wouldn't prove to be needed after all or can be deferred until a less politically sensitive time - such as after the next election. Thus such compromise regimes tend to become more rigid over time and hence more prone to crisis. This is just what happened with the operation of the European Monetary System as it evolved from frequent parity adjustments in its early days to a rigidity that led to crisis in the early 1990s.

This likewise helps explain the Russian government's hesitancy to adopt a moderate devaluation to offset the effects of the oil price decline and the Brazilian government's failure to include a much needed devaluation as a part of its fall 1998 IMF program. And is so often the case, the dynamics of the defense of the pegged rate locked the government into a process that made the devaluation much more destabilizing when it eventually came. In attempting to convince the market that devaluation would not occur, Russian officials followed the common pattern of strongly denying that they were considering devaluation, arguing that it wouldn't solve the basic problems and would have catastrophic effects on confidence. Its no wonder then that the devaluation - especially when coupled with the forcing out of office of the economic reform team and numerous signs of weakness on the part of Mr. Yeltsin - served to panic rather than calm the markets. The arguments by top Russian officials against devaluation sadly turned out to be self-fulfilling prophecies.

Currency Boards to the Rescue?

The decreased effectiveness of compromise exchange rate regimes in the face of high capital mobility is one of the factors underlying the resurgence of interest in currency boards. They are essentially a strong form of fixed exchange rates under which the government gives up control of domestic monetary policy. Once common among British colonies, currency boards had been out of fashion for some time (Hong Kong being a prominent exception). Then in the 1990s a revival began. In recent years, Argentina, Bulgaria, Estonia, and Lithuania have all adopted currency boards, in some cases quite successfully. They have become the policy of recommendation for Wall Street Journal editorials. They became a major source of concern in the official international financial community when the idea was flirted with by President Suharto during the Indonesian crisis. There have also been a number of calls that with the failure of its pegged rate real plan, Brazil should replace its current float with a currency board.

Currency board enthusiasts have been calling for a currency board for Russia for years and this was seconded by George Soros in his famous letter to the Financial Times in August 1998 that some have seen as the spark that ignited the crisis. Soros called for a substantial devaluation of the ruble to be followed by the establishment of a currency board. These ideas were taken quite seriously by the government team formed Mr. Chernomirdin during the brief period before his name was withdrawn in the face of two and a probable third refusal by the Duma to confirm his appointment. Interestingly, one popular version of the currency board proposal called for an initial huge monetary expansion to pay back wages, euphemistically labeled a controlled monetary emersion, to be followed by strict discipline under a currency board. The credibility of this print now, sober up later strategy would obviously have been the subject of some doubt.

Currency boards are not just a fad. They are one of the most effective forms of fixed exchange rates. Where their strongest backers go astray is in recommending them for all countries. While there are costs and benefits to both fixed and flexible exchange rates, these cost-benefit ratios vary systematically across countries. One of the most important developments in post war international monetary analysis, pioneered by Robert Mundell, is the theory of optimum currency areas.[1] This approach lays out the major factors which influence these cost-benefit ratios and make it desirable for some countries to choose fixed rates and other to choose flexible ones. Many of these criteria are complex and difficult to make operational, but one of the most important is economic size. The intuition is straightforward. Under fixed rates the domestic economy must adjust to its international sector while under flexible rates the international sector must adjust to the domestic economy. The larger the economy, the less dependent on international trade it tends to be.

[1] For discussion of this concept and its applications see the analysis and references in Paul Masson and Mark Taylor, eds., *Policy Issues in the Operation of Currency Unions*, (Cambridge University Press, 1993) and Richard J. Sweeney, Clas Wihlborg and Thomas D. Willett, eds. Exchange Rate Policies for Emerging Market Economies (Westview Press, 1999).

Thus for a large economy like the United States, flexible exchange rates make sense, while for a small economy like Luxembourg or Estonia fixed exchange rates are more appropriate. Economists often disagree over just where the dividing line should be drawn - for example, Austria has found fixed rates to work well for it while its similar sized neighbor - Switzerland - has continued to opt for a flexible rate. But despite the existence of such (quite sizable) gray areas, the large size and limited international trade ratios of Brazil, Indonesia and Russia clearly put them on the flexible rate end of the spectrum.

Soros is right that Russia desperately needs financial discipline. But, the discipline effects of pegged rates and IMF program didn't work in Russia. There must be sufficient domestic support for such external discipline to work. Sadly Russia is not close to that stage. Nor for a large size economy like Russia would a fixed exchange rate be the most effective mechanism by which to attempt to impose discipline. For such economies, efforts to impose discipline must focus primarily on domestic institutions. Even under currency boards there are ways to cheat and with the current political situation in Russia there is little question that this is just what would happen. Institutional reforms like balanced budgets, central bank independence, currency boards etc. can give substantial tilts to the operation of political processes. Thus over a sizeable range of political conditions they can have a major impact on policy outcomes. But there are limits to their power and until the views of a substantial proportion of the members of the Russian Parliament are drastically changed - through elections or ideological conversion - there is little chance that the adoption of a currency board would be any more effective in imposing discipline on Russian budgetary policies than was the pegged rate regime in operation prior to the crisis.

The Limits of External Discipline

New York Times columnist Michael Weinstein made the interesting argument that "devaluation...could serve as a clever device by which the Government puts pressure on an obstinate Parliament to provide economic reform package" (August 20, 1998, D2). While there is some hope that this may work for Brazil, the reverse was sadly the case for Russia. The Communist controlled Duma, instead of recognizing the need for fiscal reform, blamed the crisis on Mr. Yeltsin's government and called for his resignation. During the period over which the terms of the debt moratorium were supposedly being worked out, Mr. Yeltsin responded to this domestic political challenges by firing his whole cabinet and bringing back Viktor Chernomyrdin as Prime Minister.

But even Mr. Chernomyrdin was too reformist for the Duma. The prospect of a third defeat of Mr. Chernomyrdin's nomination, which would have triggered new elections, led Mr. Yeltsin to nominate instead his Foreign Minister Yevgeny M. Prinakov. With no substantive economic background himself, Mr. Prinakov was induced to agree to an economic team dominated by anti-reform officials. The chief economic minister was a former head of Gosplan, the state planning agency in the days of the Soviet Union. Perhaps the most telling sign of the plummeting political fortunes of reformers in the Russian government was the reappointment of Viktor Gerashchenko as head of the Central Bank. Mr. Gerashchenko had presided over Russia's quadruple digit inflation of the early 1990s. Famous for his denial of any connection between his printing presses and inflation - that was just a Western theory - he had been dubbed the worst central banker in the world.

Far from being a spur to needed reforms, as has been the cases in Mexico, Thailand, and Korea, in Russia the crisis was taken as an excuse for anti reformers to seize greater power. Clearly the discipline of the international financial markets and IMF conditionality did not work. Russia is a large country and it is not surprising that faced with what he likely perceived to be a choice between proper economic policies and political survival, Mr. Yeltsin chose the latter. If one is holding onto political power only by a thread, long run economic costs are unlikely to be given substantial weight in a political leader's decision calculus. The debt moratorium fits this picture perfectly. Since private international investment inflows had already temporarily dried up, the moratorium carried little immediate economic costs while providing substantial relief from short-term financial pressures. The major economic costs would come later in the form of substantial delays before the Russian government, banks and firms could return to international financial markets.

Under Mr. Kirigenko's government, the likely length of time that Russia would be excluded from international financial markets was a source of concern. When it became clear that initial plans to favor domestic over international investors in the terms of debt restructuring would likely freeze out future Russian borrowing abroad for a substantial period, this strategy was shelved. It was announced that foreign and domestic lenders would be treated equally. But Mr. Kirigenko's farsightedness, as limited as it was, proved too much for Mr. Yeltsin to tolerate when he viewed his political survival to be at stake Kirigenko and his team were fired.

While the Western loans to the Yeltsin government in the summer of 1998 did not work, making them was not a mistake. Any objective political economy analyst would have to conclude that the odds were against the strategy working. But the stakes were high. Even a relatively small probability that Western policy conditional loans would help the reform process was worth a substantial investment. Given the national defense costs of the Cold war, generous Western financial support is a drop in the bucket. The 1998 IMF led package was quite substantial, over $22 billion, and it was given at a pivotal time. Critics of IMF and Western government aid to Russia have argued that it has focused on the wrong objectives and allowed the Russian government to delay needed economic reforms. There is some truth to this argument, but the most extreme critics go much too far when they argue that it would have been better to give no aid at all.[2]

Counsels of perfection are often the enemy of good policy. The process of economic and political reform in Russia has been painfully slow and there have been many steps backwards as well as forward. But as poor as the economic policy performance of the Yeltsin government has been, it has been superior to what would have been pursued by the most likely alternative governments. It appears likely that the West tended to be overly optimist about the prospects for substantive reform, but IMF and Western government aid helped support the least worse of a bad set of alternatives. That is not the type of program one can get very enthusiastic about, but given the stakes it was worth pursuing.

The July 1998 IMF program came at a critical time.[3] While having brought inflation down dramatically through tight monetary policies, Russian economic policy had catered far too much to the interests of the financial and industrial oligarchs. Tax collection remained dismally low and considerable hardships were being generated by mounting averages in government wage and pension payments. Privatization and economic restructuring likewise continued to be slowed by an unholy alliance of the populist attitudes of the communist controlled Duma and the oligarchs' special interests. Mr. Yeltsin continued to vacillate between supporting reform and catering to political interests. With his appointment in March 1998 of a cabinet headed by Sergei Kirigenko, Mr. Yeltsin took a strong step in the direction of reform. At the same time Russia had been hit by serious adverse international shocks, the drop in oil prices and rise in risk premia on emerging market debt. It was always uncertain how much of the reforms planned by Mr. Kirigenko's team

---

[2] See Clifford Gaddy and Barry Ickles "Russia's Virtual Economy," *Foreign Affairs*. September/October 1998 for a perceptive pessimistic outlook for the prospects for near term Russian reform.
[3] On the pivotal nature of the state of the reform process in the summer of 1998 see Grigory Yavlinsky "Russia's Phony Capitalism," *Foreign Affairs*, May/June 1998.

would be blocked by the Duma, but it was clear that Messrs. Yeltsin and Kirigenko were making a major push that deserved to be supported by the West.

The Yeltsin - Kirigenko government, the IMF, and the major Western governments were all in broad agreement about what needed to be done. So what was the problem? As is so often the case - the answer lies in domestic politics, both in Russia and the major Western nations. The danger that the communist dominated Duma would block key elements of needed reform was substantial. Thus Russia did not qualify for an IMF loan by normal criteria. Financial support was a high-risk gamble that should have been made, but not by the IMF!

Saving the IMF

The recent request for additional IMF funding became a focal point for criticism of IMF-US Treasury policy. With the large-scale programs associated with the Asian crisis, the Fund had almost run out of lendable money. The Fund did need a quota increase, but the actual amount of money that the IMF provides in its stabilization programs are not their most important element. Rather it is the signal that agreement between national and IMF officials on a policy program sends to the private financial markets. The Fund serves as a monitor of the seriousness of intentions by national governments to initiate substantive policy reform and the conditionality of IMF programs gives governments added incentives to carry through on these intentions. IMF aid is handed out in installments, and if countries' policies deviate too far from the agreed guidelines, further installments will be withheld: at least that’s the theory and sometimes practice.

When this strategy is believed to be working, IMF programs unleash private capital flows that dwarf the magnitudes of direct IMF aid. But for this crucial monitoring and signaling function of the IMF to be effective, its programs must be credible. Everyone expects some slippage from the announced targets of IMF programs, but if the backsliding is too great, then the credibility of the IMF’s signal is damaged. While the Mexican rescue operation was a great success on this score, the mixed initial results from the IMF's Asian programs had raised questions in the market about the credibility of IMF programs. From this standpoint, 1998 was a particularly bad time to risk further damage to the IMF's credibility. Yet it was clear that there was a good chance that the oligarch-communist coalition would succeed in blocking important elements of the necessary reforms in Russia.

Why face the risk of a damaging blow to IMF credibility by lobbying it to make an essentially political loan? Surely, such a high-risk loan package should be financed directly by the major Western governments, not the IMF, just as the U.S. had funded post war European economic recovery through the Marshall Plan.

The answer lies in the strong domestic political opposition to such funding in the major Western countries. The Mexican bailout was extremely unpopular in the U.S. Congress and indeed Congress refused to authorize U.S. funding. The U.S. share of the rescue package ultimately came from the Exchange Stabilization Fund, which is under the direct control of the Executive. Despite the success of the peso rescue package, opposition in Congress both to IMF programs and unilateral financial aid had if anything strengthened since the Mexican crisis. A curious combination of critics from the far right and the far left almost succeeded in blocking funding of the U.S. share of the internationally agreed increases in IMF quotas. The Clinton administration clearly understood that it would be extremely difficult, if not impossible, to get the U.S. share of a G-7 financial aid package for Russia through Congress. Thus political expediency called for pressuring the IMF to put up the funds instead. This was quite understandable - but it was wrong!

One popular explanation of what went wrong with the IMF program was that it just didn't put up enough money to handle the situation. It is true that the IMF loan was not sufficient to finance all of the debt coming due, but that was never its purpose. It was not just the niggardliness of Western governments that limited the size of the IMF package. As discussed above, the idea of

IMF programs is not to be the primary source of financing of balance of payments or government budget deficits, but to establish the credibility necessary to stimulate private financing. Of course, establishing such credibility requires that there be sufficient official funds available to handle emergencies and provide some bridge financing to help cover lags in implementing policy reforms, but the key to restoring credibility is in the implementation of policy reforms. The conditionality of IMF programs gives national governments greater incentives to implement economically necessary, but politically unpopular, policies and signals that the IMF believes that the government in question has serious intentions of initiating and carrying through such policies.

For the July 1998 IMF program this was the situation with respect to the intentions of the executive branch of the Russian government, and the announcement of the program was successful in establishing more favorable private sector expectations. This was reflected in a substantial fall in interest rates. The key blow to confidence was not external events, but the emasculation of the government's proposals in the communist controlled Duma. Had the Duma been willing to endorse a tax program along the lines agreed between Mr. Kirigenko's government and the IMF, there would have been little trouble in financing the government debt as it came due.

Political conflicts between reformers and populists are nothing new. Indeed they are the typical case with IMF programs. It is in just such cases that the IMF has greatest leverage. Despite leftist critiques of the IMF as a big bully dictating terms to weak nations to protect the interests of the global capitalist class, the IMF in fact has little influence on politically united countries, large or small. If the country is united behind reform, IMF arm-twisting is unnecessary. If the country is united against reform, IMF arm-twisting is useless.

It is in strengthening the hand of reforms in politically divided countries that the IMF is most effective. But the increased leverage given to reforms by IMF programs is not always sufficient to swing the balance in this favor, and the recent Russian experience is one of these cases. Attention is now being properly focused on possible reforms of the IMF. While much of the ideological rhetoric of both the left and the right falls far from the mark, there have been many mainstream criticisms and proposals that deserve careful attention.[4] Particularly relevant to the current discussion is the need to offer greater protection to the IMF from politically motivated manipulation by the major powers and to strengthen the IMF's ability to enforce its agreements on policy conditionality. As critics have noted, IMF officials sometimes tend to become committed to programs and national governments can exploit this to gain lax enforcement. The IMF needs both to beef up its expertise in political analysis and to adopt internal reforms that stiffen its back in dealing with borrowing countries. None of this will be easy, but progress can be made.

An Optimistic Outlook for the Future

It's easy to understand fears that the global financial system is falling apart. Calls for a new international financial architecture are multiplying, without consensus on an agenda for action. That's not surprising. There are no quick fixes to the problems of crony capitalism, special interest politics, and outright corruption that plague so many of the emerging market countries; and problems of special interests and short time horizons have even been known in our more mature democracies.

The recent crises highlight the dangers of premature international financial liberalization in countries where cronyism and moral hazard problems are prevalent. While there is considerable disagreement among experts about the best ways to sequence reforms in such conditions, there is considerable agreement about ways to avoid repeats of the recent disasters. The big stumbling block is not a lack of knowledge, but the need to strengthen domestic political systems enough to

---

[4] Recent discussions include Martin Feldstein, "Refocusing the IMF" Foreign Affairs, March/April 1998, Stanley Fischer "In Defense of the IMF" Foreign Affairs, July/August 1998, David D. Hale, "The IMF, Now More than Ever' Foreign Affairs, November/December 1998, and Thomas D. Willett, "A Soft Core Public Choice Approach to IMF Reform" Claremont Working Paper, 1999. The latter paper has extensive references to the recent literature on reforming the IMF.

resist the pressures of special interests. Inevitably the results of reform efforts will be mixed and further crises will occur from time to time, but there is a good chance that they will not come again in the massive waves of the past two years.

At the international level, a lot can be done to improve our international financial architecture. Better provision of information, greater transparency for the IMF, etc. are useful. Proposals for international regulation of capital flows are not. None of the recent crisis has been caused primarily by unjustified destabilizing speculation. But neither have international financial markets been the strong force for international discipline over national financial policies foreseen by many neo liberal theorists.[5] Too often capital inflows have helped finance budget deficits and mask underlying financial problems. International financial markets can fall prey to excessive optimism as well as excessive pessimism. Large surges in inflows of financial capital can be difficult to absorb productively and may increase a country's vulnerability to future outflows. They are a legitimate area of concern for government policy makers and at times national measures to discourage short term inflows may be both desirable and effective. However, many of the recent cases of excessive inflows have been generated in large part by governments themselves.

Moral hazard has played an important role. Beliefs that if things go badly, investors will be bailed out encourages inappropriate risk taking. While IMF programs have been fairly criticized for encouraging moral hazard, most of the moral hazard in the global financial system has been generated by national governments. Government debt played little role in the Asian crisis, but it was central to both the Mexican and Russian crises. The IMF led bailout of investors in the Mexican government’s dollar denominated securities undoubtedly contributed to the willingness of international investors to purchase Russian government bonds despite the horrible shape of Russian

[5] See Thomas D. Willett “International Financial Markets as Sources of Crisis or Discipline.” Claremont Working Papers, 1999. A shortened version is forthcoming as a Princeton Essay in International Finance.

public finances. This private international funding gave the Russian government more time to get its finances in order, but sadly, also reduced the pressures to do so. And it made the crisis much harsher when it finally came.

The unwillingness of the IMF and Western governments to bail out these investors sent shock waves through the global financial markets and imposed considerable hardships on many emerging market countries seeking international funds. Global financial markets are finally beginning to return to normal, however, despite the additional shock of the Brazilian crisis. This episode has been painful, but as a consequence of the fall in perception of moral hazard in the system the long term effect is likely to be a much better balanced operation of markets worldwide.

Indeed, rather than extrapolating recent experiences into a vision of an increasingly chaotic global financial system, I see much calmer waters ahead. While many combinations of factors conspired to cause the various crises of recent years, all shared one common characteristic - adjustably pegged exchange rates. The recent crises explode the myth that adopting of pegged exchange rates is a cheap way of promoting domestic discipline. This does sometimes work, but more often the result is failure - frequently very costly failure. The popular idea that pegging the exchange rate is necessary to halt high inflation simply does not stand up to the empirical evidence. The majority of such efforts have ended in failure. A brief period of pegging may be useful as a part of a comprehensive stabilization program, but it has proven extremely difficult to exit from these pegged periods without terrible bumps.[6]

Perhaps the knottiest problem is the asymmetric time profile of costs and benefits from abandoning a peg. The resulting depreciation generates immediate economic and political costs while much of the benefit comes later; so politically there are strong incentives to try to maintain

---

[6] See, for example, the analysis and references in Richard J. Sweeney, Clas Wihlborg and Thomas D. Willett, eds. Exchange Rate Policies for Emerging Market Economies Boulder: Westview Press, 1999 and Thomas D. Willett, “The Credibility and Discipline Effects of Exchange Rates as Nominal Anchors” The World Economy, August 1998.

the peg just a little longer. Even regimes that were intended to be operated flexibly grow rigid over time. This has occurred for countries as disparate as France, Italy, Mexico, and Russia. Thus the adoption of a pegged exchange rate system - unless it's backed by strong institutional arrangements such as a currency board - is likely to worsen rather than help control the biases that plague domestic macroeconomic policy. Combine this with the one-way speculative option problem in a world of high capital mobility and pegged exchange rate regimes can become a disaster waiting to happen.

The major reason for my optimistic prognosis for the future is that over the past several years most of the more important pegged rate regimes have broken down. The combination of pegged exchange rates and high capital mobility can often be too forgiving of initial minor crimes and misdemeanors. By failing to give sufficient early warning signals financial markets may contribute to the escalation of economic misdeeds. Ultimately the day of reckoning comes, though, and the resulting crises often levy punishment that seems far too harsh to fit the crime. The adoption of more flexible exchange rates for most countries and genuinely fixed rates for those who score high on the optimum currency area criteria are not panaceas, but they will do much to dampen the surges in international financial flows that have plagued the 1990s.